

Sri Lanka

Bolstered by agriculture, the economy maintained healthy growth in 2008, though high global food and oil prices boosted inflation and widened the trade deficit. Growth will slow on depressed export demand in 2009, with the worst effects of the global downturn felt in the balance of payments, creating pressures on reserves and the exchange rate. Meeting fiscal targets for 2009 will be a challenge due to tight financial markets and a fiscal stimulus package. With major military operations expected to end in early 2009, rehabilitation and reconstruction in the north might start this year.

Economic performance

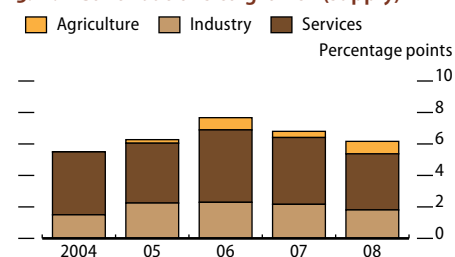
Performance in 2008 was resilient to adverse global financial and economic developments and the intensified civil conflict in the north of the country. As recession battered the United States (US) and European economies, production of export industries slowed somewhat, but overall growth slid only a little, to 6.0% from 6.8% in 2007 (Figure 3.21.1).

Agriculture recorded strong growth of 7.5%; services and industry, moderate growth. Although the Government already had a policy of maximizing agricultural production and minimizing food imports, the shortage of rice early 2008, together with sharp increases in global food prices, spurred its efforts. It launched a major drive to cultivate abandoned paddy lands, which lifted paddy production by half. Tea production was 4% higher than the previous year, though the sector underwent significant price reductions from the third quarter of the year, with the December average price dropping by 36% relative to December 2007 at Colombo auctions.

In services, at over 20% expansion the communications subsector continued to drive sector growth, of 5.6% (down from 7.1% a year earlier). Tourist arrivals and earnings from tourism both fell by 11% year on year, resulting in contraction in the hotel subsector for the fourth consecutive year. Transport and banking services turned in slower growth than in the previous 2 years. Global conditions affected clothing, which slowed to around 2% annual growth and was the main factor reducing industrial growth to 5.9% from 7.6% a year earlier.

Annual average inflation in 2008 was high at 22.6%, well above the prior-year's 15.8%. Year-on-year inflation peaked in June at 28.2%, and stepped down gradually to 14.4% by December (Figure 3.21.2). In fact, the economy had experienced a persistent rise in inflation since 2006, a phenomenon linked primarily to bank-financed government deficits. However, June's spike stemmed from higher fuel and food prices, originating in the lifting of subsidies on fuel in 2006 and on electricity in 2008, which allowed global oil prices to be fully reflected in price developments.

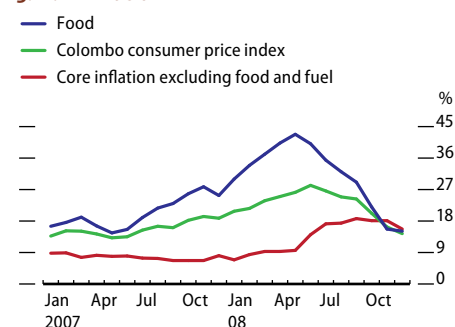
3.21.1 Contributions to growth (supply)



Source: Central Bank of Sri Lanka, available: <http://www.cbsl.gov.lk>, downloaded 9 March 2009.

[Click here for figure data](#)

3.21.2 Inflation



Source: Department of Census and Statistics of Sri Lanka, available: <http://www.statistics.gov.lk>, downloaded 20 February 2009.

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To help deal with escalating oil prices, the Ceylon Petroleum Corporation had made hedging agreements with commercial banks from 2006, but with tumbling oil prices in the second half of 2008 it incurred heavy losses. An order by the Supreme Court, which had earlier suspended the agreements on account of wrong procedure, was removed in January 2009, compelling the Corporation to honor its payments to the banks. It is unclear whether these payments will be made, as the central bank has since issued a directive to stop the payments.

The central bank tightened its monetary policy in 2008. It lowered its reserve money growth targets on three occasions during the year from 14.7% to 9.7%, in a bid to restrain rising inflation pressures. As a result of tight liquidity and the resulting high interest rates, growth in credit to the private sector decelerated to around 9% toward the end of the year from the 20–26% seen in 2007 (Figure 3.21.3). Real interest rates were negative for most of the year, becoming positive only in the last 2 months, as inflation dropped below 20%.

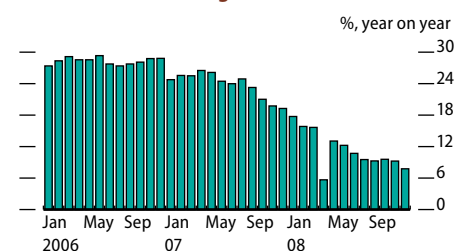
Late 2008 saw a liquidity shortfall in the market precipitated by the global financial crisis, which caused an outflow of dollars from the system. The central bank reduced the statutory reserve requirement of commercial banks by 225 basis points in two steps in 2008 to inject liquidity into the market. It further reduced this requirement by 75 basis points in February 2009, releasing SLRs9 billion into the system. The central bank has also been injecting additional liquidity by providing repo facilities to commercial banks and primary dealers.

The high global food and fuel prices prompted the Government to take certain fiscal measures that resulted in revenue losses in 2008. These steps included reducing import tariffs on food and cutting value-added tax on gasoline from 15% to 5%. However in May 2008, it removed an import duty waiver that had been in effect on gasoline imports to cross-subsidize the price of diesel, and imposed a duty of SLRs20 per liter. The Government has resorted to ad hoc cesses to raise additional revenue, and cess revenue now accounts for 4.3% of the total tax take, up from 1.4% in 2006. This development has made the tax system increasingly complex, and the 2009 budget called for a presidential task force to plan a rationalization.

Revenue and capital expenditure continued to underperform relative to budgeted levels. Although the deficit continued its narrowing trend of 2006 and 2007, it stayed high at nearly 7% of GDP in 2008 (Figure 3.21.4). On the expenditure side, fertilizer subsidies exerted heavy pressure on the budget, because of the increase in international prices in the first half. Full-year expenditure was driven mainly by these subsidies and defense, at the expense of the ambitious public investment program, which, due to a shortage of counterpart funds, is estimated to have spent 17% less than the budgeted amount

The 2009 budget was presented in a deteriorating global scenario, which poses specific challenges to the Sri Lankan economy in terms of raising funds in the international market, risks to exports, falling reserves, and pressure on the rupee. This year the Government was also facing difficulties in meeting counterpart funding commitments. However, while some support was provided to foreign exchange-earning industries (such as tea, garments, hotels, and rubber), there are no specific

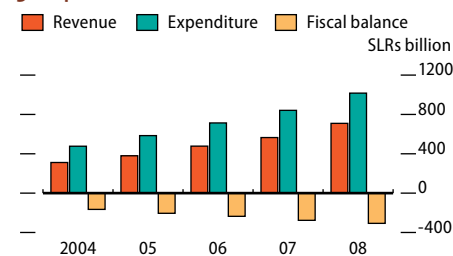
3.21.3 Private credit growth



Source: CEIC Data Company, Ltd., downloaded 11 March 2009.

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3.21.4 Fiscal indicators



Source: Central Bank of Sri Lanka, available: <http://www.cbsl.gov.lk>, downloaded 20 February 2009.

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measures in the budget proposals to address these challenges. After debt repayments and interest payments, defense makes up the largest single cost category, accounting for 10% of total expenditure.

In the revenue proposals, income tax brackets have been expanded resulting in lower tax payments for all levels of income. Value-added tax has been brought down from 15% to 12%. Cesses have been imposed and rates increased on items already covered, to encourage domestic industries. The budget deficit is expected to come down to 6.5% in 2009, from an estimated 7% of GDP in 2008.

The Government's total external foreign currency commercial debt declined from \$485 million at end-2007 to \$460 million a year later. The authorities have been increasingly turning to foreign commercial borrowing in recent years, the share of which, in total foreign debt, rose from 5% in 2003 to 13% in 2007. As the maturities are relatively short, the roll-over risk of this debt is high in the current environment. The central bank had proposed to borrow \$300 million in the international capital market in the latter part of 2008, but failed to push through with this because of the prevailing global conditions. For example, the sovereign spread for Sri Lanka rose to about 1,300 basis points in October. The debt-to-GDP ratio, at 85% at end-2007, was down to 78% 12 months later, aided by high nominal GDP growth.

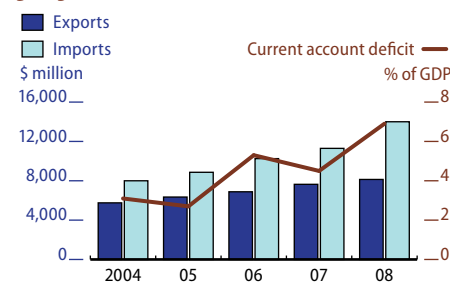
The most direct effect of the global economic turmoil in the current account was on the trade deficit: slowing export demand and high global prices widened it by 61% to \$5.9 billion; the import bill rose by 24.0%, mainly on high oil prices. Clothing exports were affected by recession in the main markets and grew by only 5% during the year.

On a positive note, the Generalized System of Preferences, plus concessions available from the European Union, was conditionally extended for 3 more years. This was a relief to a clothing industry already affected by worsening global conditions. Despite healthy growth of remittances (of around 16% to \$2.9 billion), the current account deficit is projected at \$2.9 billion, or about 7.1% of 2008 GDP (Figure 3.21.5). The capital and financial account was in surplus owing to large inflows, including Sri Lanka Development Bonds of \$250 million, a syndicated loan of \$150 million, foreign direct investment, and a credit line from the Islamic Republic of Iran for oil.

The central bank has intervened in the foreign exchange market since 2007 to keep the Sri Lanka rupee stable against the US dollar. With the eruption of the global financial crisis, foreign exchange drained from the country, occasioned by a fall in nonresident holdings of Sri Lankan Treasury paper and the settlement of large petroleum bills in the last quarter of 2008. This, with high inflation, exerted depreciation pressure on the local currency (Figure 3.21.6). In response, the central bank intervened, seeking to maintain the rupee at about SLRs₁₀₇/\$1, but this intervention entailed a large drop in official international reserves from \$3.4 billion at end-August (Figure 3.21.7) to \$1.8 billion at end-December 2008 (equivalent to 3 months and 1.5 months of imports, respectively).

During the fourth quarter, the central bank relaxed its stance somewhat and allowed greater flexibility in exchange rate movements, primarily because of a sharp decline in export prices, lower export demand due to the slowing global economy, and the sharp appreciation

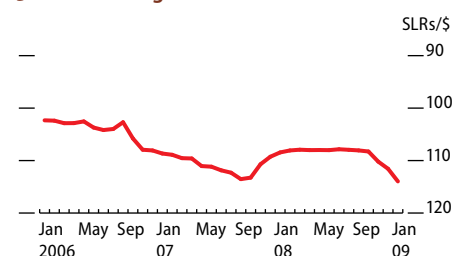
3.21.5 Current account indicators



Sources: Central Bank of Sri Lanka, available: <http://www.cbsl.gov.lk>, downloaded 9 March 2009; staff estimates.

[Click here for figure data](#)

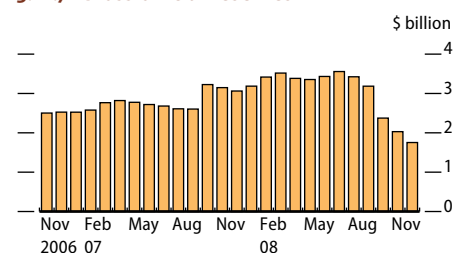
3.21.6 Exchange rate



Source: International Monetary Fund, *International Financial Statistics* online database, downloaded 10 March 2009.

[Click here for figure data](#)

3.21.7 Gross official reserves



Source: Central Bank of Sri Lanka.

[Click here for figure data](#)

of the US dollar against most major currencies. To contain imports, the central bank also imposed a 100% margin (deposit) when traders opened letters of credit for selected imports in November. The imports covered under this include electrical items, liquor, confectionery, and household items. This created great difficulties for small and medium-sized importers who generally rely on an advance against imports credit scheme, and find it hard to pay upfront.

Economic prospects

The main concerns for 2009 and 2010 are slowing growth, a deteriorating balance of payments, and meeting fiscal targets. Although the domestic financial system has reported no direct losses from foreign securities, the global financial crisis and economic slowdown mean that Sri Lanka faces tighter access to capital markets and weaker demand for its exports.

Growth is expected to fall to 4.5% this year as the global slowdown deepens, affecting export industries. In addition, last year's exceptional agricultural performance is unlikely to be repeated. On the positive side, there are signs that the civil conflict could end this year, paving the way for reconstruction, which should give a stimulus to the economy if financing is available. Growth is forecast to rebound to 6.0% in 2010, reflecting a measure of global economic recovery (Figure 3.21.8).

Inflation dropped to 7.6% in February 2009, reaching single digit levels for the first time since July 2006. It will continue its downward trend, following global prices lower, and is expected to average 8.0% this year. However, inflation has historically been high and has been affected by government borrowings from the domestic banking sector. Keeping inflation low will therefore depend on the Government's borrowing program as well.

The Government expects to ease the monetary policy stance a little this year, according to the Financial Road Map for 2009 released by the central bank. That document also states that the growth of broad money is targeted at around 14% this year, which is expected to facilitate the Government's projected growth rate of 5–6%. The targets have been set with annual inflation in mind of 9% this year. With inflation falling, the central bank cut its policy rates by 25 basis points in February, the first change in 2 years. Market interest rates can also be expected to fall. Easing of monetary policy is intended to stimulate the economy and help counter the negative impact of the global slowdown.

Since Sri Lanka's financial system was not exposed to the toxic assets of the US and European systems, it should remain largely unscathed. However, nonperforming loans seem to be rising, because industries such as clothing, tea, and construction are facing difficulties. These problems will persist during 2009 when borrowing sources stay limited.

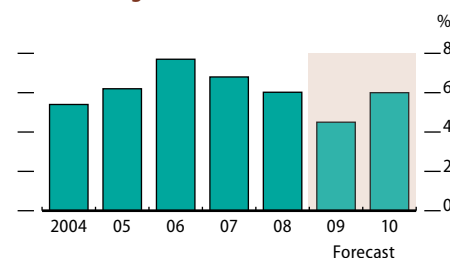
Maintaining fiscal discipline in 2009 will remain a major challenge. The budget for 2009 expects the deficit to fall to 6.5% of GDP, a view underpinned by assumptions of discipline in current spending and strong revenue performance. Historically, both these targets have been hard to meet, leading to cuts in the capital budget to maintain the deficit at a manageable level. The public investment program will also depend on the Government's ability to raise funds in international capital markets,

3.21.1 Selected economic indicators (%)

	2009	2010
GDP growth	4.5	6.0
Inflation	8.0	6.0
Current account balance (share of GDP)	-7.5	-7.0

Source: Staff estimates.

3.21.8 GDP growth



Sources: Central Bank of Sri Lanka, available: <http://www.cbsl.gov.lk>, downloaded 9 March 2009; staff estimates.

[Click here for figure data](#)

which will remain problematic this year: Sri Lanka's sovereign rating was downgraded in 2008 both by Fitch (to B+ from BB-) and Standard & Poor's (to B from B+). The rating was further downgraded by Fitch to B in February this year.

With revenue measures focusing on protecting the poor and tax collection increasingly depending on trade-related taxes, the implications for revenue collection may be significant in the current global context. The Government announced a stimulus package of SLRs16 billion with cuts in energy prices and incentives for exporters in 2008. The package includes the removal of a 15% surcharge on electricity for the tourism, garments, leather, and rubber industries, lifting the cess tax on manufactured rubber exports and giving tea producers price support through state purchases.

The sources for funding the package and its implications for the budget deficit are still unclear. The interventions, which the Government sees as necessary to maintain growth, would make it harder to meet fiscal targets in 2009; the fiscal space for such interventions is also limited on account of the high deficit.

In terms of the trade balance, the global downturn's impact on exports will be softened by a lower import bill (largely reflecting lower fuel prices). The current account deficit will remain high at around 7.5% of GDP in 2009, given lower exports and slowing remittances. Exports will fall due to lower external demand and lower prices, which have already affected the tea industry. With exports and GDP growth expected to pick up during the second half of 2010, the current account will start to improve that year.

As international financial markets remain tight, financial inflows will be substantially lower than in 2008. This, coupled with falling reserves, will pose serious risks to the economy. The Sri Lanka rupee is expected to depreciate further in the first half of this year. Given the relatively low foreign exchange reserves, the Government's decision to allow more depreciation in the exchange rate in late 2008 was correct. The overvalued currency is hurting exports, and exporters have been lobbying for a larger depreciation. However, any depreciation of the rupee will increase debt repayments in rupee terms and add to the fiscal burden. Considering all these factors, the Government needs to follow a more active exchange rate policy, which should be supported by greater fiscal restraint to minimize risks and maintain export competitiveness.

The Government announced strategies to boost reserves in January 2009, such as currency swaps with some central banks, promotion of investments in Treasury bills and bonds among the Sri Lankan diaspora, bonus interest on nonresident and resident foreign currency deposits, and a concessional final income tax for new foreign exchange inflows. With markets tight and investors cautious and risk averse, the effectiveness of these measures remains to be seen.

On the positive side, the Government is negotiating with the International Monetary Fund a Standby Facility of \$1.9 billion. An agreement would provide support to reserves and have other positive effects such as of improving investor confidence and support for the exchange rate.

3.21.1 Development challenges

The contribution of manufacturing to GDP has expanded only marginally since the 1970s. The economy has moved from agriculture to services, but the manufacturing base has remained concentrated on garments, processed food, and chemical and plastic products. Since the opening of the economy in the late 1970s, export processing zones have been set up and wide-ranging incentives offered to attract foreign direct investment for industrial development.

With the 2008 budget, the Government started rationalizing tax exemptions provided to foreign companies, which have been costly in revenue terms. In the 2009 budget, it raised the issue of broadening manufacturing's base. But doing this and attracting investment may be difficult during the global recession, and the success of both will depend on improving the investment climate.

The 2009 budget proposed to set up a presidential task force to prepare a national tax policy. The current tax system is complicated and has been subject to ad hoc changes, and although progress has been achieved over the last few years to broaden the tax base, the changes in the 2009 budget do not support this trend.

It is a positive development that the Government has recognized the importance of simplifying the tax system and has proposed to set up a task force for this. However, such initiatives have fallen far short of expected outcomes in the past on numerous occasions. The challenge is to ensure that the proposed task force will not meet a similar fate.